REPORT OF EXAMINATION
OF THE

CALIFORNIA INSURANCE COMPANY

AS OF
DECEMBER 31, 2006

Participating State
and Zone:

California

Filed March 28, 2008

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San Francisco, California
January 24, 2008

Honorable Alfred W. Gross
Chairman of the NAIC Financial
Condition (EX4) Subcommittee
Commissioner of Insurance
Virginia Bureau of Insurance
Richmond, Virginia

Honorable Kent Michie
Secretary, Zone IV-Western
Commissioner of Insurance
Department of Insurance, State of Utah
Salt Lake City, Utah

Honorable Steve Poizner
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Chairman and Commissioners:

Pursuant to your instructions, an examination was made of the

CALIFORNIA INSURANCE COMPANY

(also referred to as the Company) at its financial accounting office located at 10805 Old Mill Road Omaha, Nebraska 68154. The Company's statutory home office and main administrative office are located at 950 Tower Lane, Foster City, California 94404.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2001. This examination covers the period from January 1, 2002 through December 31, 2006. The examination was made pursuant to the National Association of Insurance Commissioners' plan of examination. The present examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions, an evaluation of assets, and a determination of liabilities as of December 31, 2006, as deemed necessary under the circumstances.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: corporate records, officers' and employees' welfare and pension plans; growth of Company; business in force by states; loss experience; and sales and advertising.

SUBSEQUENT EVENTS

In December 2006, the Company filed an application for redomestication with the California Department of Insurance (CDI) pursuant to California Insurance Code (CIC) Section 709.5(b), with plans to redomesticate to the State of Iowa. In March 2007, the application for redomestication was withdrawn by the Company.

In 2007, the Company submitted a Voluntary Plan Unemployment Compensation Disability Insurance Policy (the Voluntary Plan Policy) to the CDI for approval. The Voluntary Plan Policy is offered to employers who are SolutionOne policyholders and provides short term disability benefits and paid family leave benefits as a legal alternative to mandatory Short-Term Disability provided through the California Employment Development Department and is authorized by Section 3251 of the California Unemployment Insurance Code. The Voluntary Plan Policy was approved by the CDI on December 14, 2007.

COMPANY HISTORY

On March 24, 2003, the Company was purchased as a shell company from the Coregis Group, Inc. (Coregis), and became a wholly-owned subsidiary of Applied Underwriters, Inc. (AUI), a financial services company that provides payroll and other employment services and underwrites insurance coverage to small and medium sized employers throughout the United States. As a condition of the sale, Coregis agreed to reinsure all reported and unreported liabilities incurred prior to the date of sale. The change in ownership also resulted in new officers and directors for the Company. The Company currently has no employees.

The Company received capital contributions from AUI in the amounts of $42.1 million on February 28, 2005, and $10 million on May 31, 2005.

In May 2005, the Company began writing workers' compensation and employment practices liability insurance in California.

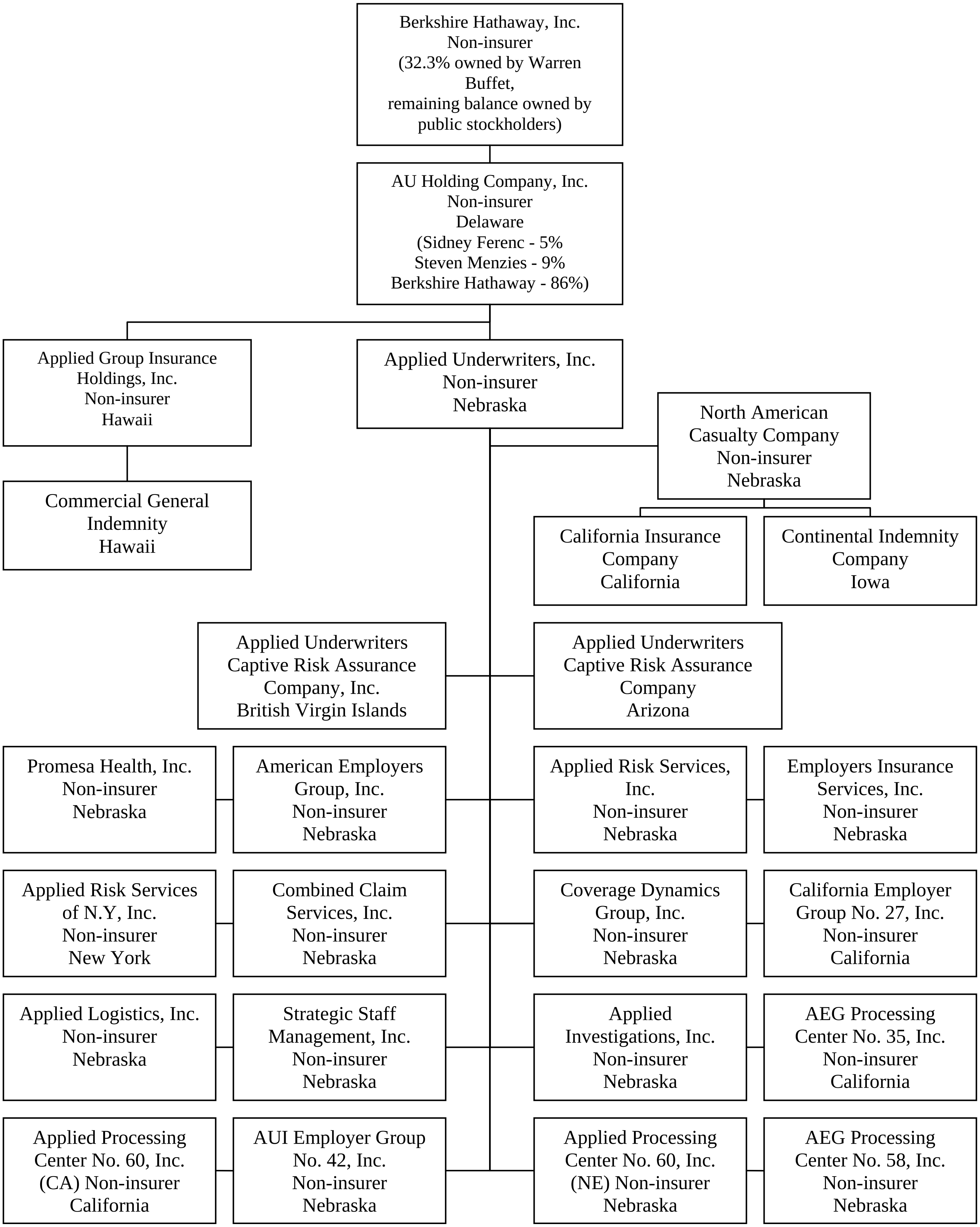
On February 1, 2006, the Company's Articles of Incorporation were amended to change the Company's corporate office location from San Francisco, California, to Foster City, California.

On May 19, 2006, Berkshire Hathaway Inc., through the wholly-owned subsidiary AU Holding Company, Inc., purchased all of the issued and outstanding shares of AUI.

On December 29, 2006, all 30,000 issued and outstanding shares of the Company's capital common stock were transferred to North American Casualty Company, a subsidiary of AUI.

MANAGEMENT AND CONTROL

As of December 31, 2006, the Company is a member of the Berkshire Hathaway, Inc., holding company system. The following abridged organizational chart, which is limited to the companies under the AU Holding Company, Inc., branch of Berkshire Hathaway, depicts the Company's relationship within the holding company system. All ownership is 100% unless otherwise indicated:


Berkshire Hathaway, Inc.
Non-insurer
(32.3% owned by Warren Buffet, remaining balance owned by public stockholders)
AU Holding Company, Inc.
Non-insurer
Delaware
(Sidney Ferenc - 5%
Steven Menzies - 9%
Berkshire Hathaway - 86%)
Applied Group Insurance Holdings, Inc.
Non-insurer
Hawaii
Applied Underwriters, Inc.
Non-insurer
Nebraska
North American Casualty Company
Non-insurer
Nebraska
Commercial General Indemnity
Hawaii
California Insurance Company
California
Continental Indemnity Company
Iowa
Applied Underwriters Captive Risk Assurance Company, Inc.
British Virgin Islands
Applied Underwriters Captive Risk Assurance Company
Arizona
Promesa Health, Inc.
Non-insurer
Nebraska
American Employers Group, Inc.
Non-insurer
Nebraska
Applied Risk Services, Inc.
Non-insurer
Nebraska
Employers Insurance Services, Inc.
Non-insurer
Nebraska
Applied Risk Services of N.Y, Inc.
Non-insurer
New York
Combined Claim Services, Inc.
Non-insurer
Nebraska
Coverage Dynamics Group, Inc.
Non-insurer
Nebraska
California Employer Group No. 27, Inc.
Non-insurer
California
Applied Logistics, Inc.
Non-insurer
Nebraska
Strategic Staff Management, Inc.
Non-insurer
Nebraska
Applied Investigations, Inc.
Non-insurer
Nebraska
AEG Processing Center No. 35, Inc.
Non-insurer
California
Applied Processing Center No. 60, Inc.
(CA) Non-insurer
California
AUI Employer Group No. 42, Inc.
Non-insurer
Nebraska
Applied Processing Center No. 60, Inc.
(NE) Non-insurer
Nebraska
AEG Processing Center No. 58, Inc.
Non-insurer
Nebraska

Management of the Company is vested in a three-member board of directors elected annually. The following are the directors and principal officers serving as of December 31, 2006:

Directors

Name and Residence	Principal Business Affiliation
Sidney R. Ferenc Omaha, Nebraska	Chairman and Chief Executive Officer Applied Underwriters, Inc.
Steven M. Menzies Omaha, Nebraska	President and Chief Operating Officer Applied Underwriters, Inc.
Jeffrey A. Silver Omaha, Nebraska	Attorney

Principal Officers

Name	Title
Steven M. Menzies	President and Treasurer
Jeffrey A. Silver	Secretary
Robert L. Stafford	Vice President of Finance
Ellen M. Gardiner	Vice President of Underwriting and Chief Actuary
Carl DeBarbie	Vice President of Marketing

Management Agreements

Agency Agreement: Effective June 1, 2005, the Company entered into an Agency Agreement with Applied Risk Services, Inc. (ARS). Under the agreement, ARS is appointed as the Company's agent for underwriting and servicing the Company's workers' compensation insurance policies. ARS is authorized to collect and account for all premiums written by the Company. For this service, the Company pays ARS a commission equal to the actual amount that ARS pays to brokers who produce business for the Company. During 2006, the Company paid ARS $12.7 million for the services under this agreement. The Company was not in compliance with California Insurance Code (CIC) Section 1215.5(b)(4) because it did not provide prior notice to and obtain approval from the California Department of Insurance (CDI) for this agreement. On January 10, 2007, this agreement was filed with the CDI pursuant to CIC Section 1215.5(b)(4) and is currently under review.

Claim Services Agreement: Effective June 1, 2005, the Company entered into a Claim Services Agreement with ARS. Under the agreement, ARS provides all claims adjusting services to the Company with respect to any claim that is made under any of the Company's policies which involve an actual or alleged loss. The agreement states that compensation to ARS is based on actual cost without a profit factor built into cost. Additionally, the agreement states that indirect and shared expenses are allocated in accordance with a method of cost allocation in conformity with Statement of Statutory Account Principles (SSAP) No. 70. During 2006, the Company paid ARS $18.9 million for the services under this agreement. The Company was not in compliance with CIC Section 1215.5(b)(4) because it did not provide prior notice to and obtain approval from the CDI for this agreement. On January 10, 2007, this agreement was filed with the CDI pursuant to CIC Section 1215.5(b)(4) and is currently under review.

Management Services Agreement: Effective July 1, 2005, the Company entered into a Management Services Agreement with Applied Underwriters Inc. (AUI). Under the agreement, AUI provides the Company with management, investment, and loss prevention services. Compensation to AUI for the services under this agreement is at actual cost. During 2006, the Company paid AUI $13.2 million for the services under this contract. This agreement was filed with the CDI pursuant to CIC Section 1215.5(b)(4) on August 9, 2005 and is currently under review.

Tax Allocation Agreement: Effective December 31, 2006, the Company became a participant in a tax allocation agreement with Berkshire Hathaway, Inc. and its approximately 580 affiliates. Under this agreement, the consolidated tax liability is allocated in the ratio that each affiliate's separate return tax liability bears to the sum of the separate return tax liabilities of all affiliates that are members of the consolidated group. Affiliates that generate a net tax benefit (i.e. net operating loss) are entitled to reimbursement from affiliates that generate a separate return tax liability. Each affiliate with a separate return tax liability are assessed an amount equal to the ratio that its separate return tax liability bears to the sum of the separate return tax liabilities of all affiliates times the sum of the net tax benefits generated by all affiliates with a net tax benefit. However, in no event is an affiliate assessed an amount in excess of the affiliate's separate return tax liability. To the extent that the tax benefits allocated above to an affiliate that generated the net tax benefit is less than the refund that would have resulted if the affiliate filed a separate Federal Income Tax return, Berkshire Hathaway Inc. will pay the difference between the amount allocated to the affiliate and the amount of such refund as a contribution to capital.

The Tax Allocation Agreement was reviewed and the following deficiencies were noted: The agreement does not address payments owed or refunds due as a result of adjustments to a previously filed tax return (whether by reason of any carryback, an amended return, a claim refund, an IRS audit or otherwise). The CDI requires that amounts due as a result of adjustments be paid by or remitted to the parties no more than 10 days before or 30 days after any such payments are made or refunds received by the ultimate taxpayer. Additionally, the amount of any adjustments should include interest actually due to the parties. The agreement does not cover estimated taxes. The CDI requires that if estimated taxes are paid on a consolidated basis, the subsidiary should remit its estimated tax payment to the filing parent company no earlier than 10 days prior to the due date of the estimated taxes. Also, the agreement should provide that the subsidiary's liability shall be reduced by the amount of any estimated taxes paid. The CDI also requires that if the amount of a subsidiary's total estimated tax payments differs from the amount of its actual liability as determined on a separate-return basis, then the difference shall be paid by the subsidiary or refunded to it, not more than 30 days after the amount of the difference has been calculated. It is recommended that the Tax Allocation Agreement be amended to comply with these requirements.

Furthermore, it is noted that the Tax Allocation Agreement was not submitted to the CDI for review and approval. It is recommended that the Company submit this tax allocation agreement to the CDI for approval pursuant to CIC Section 1215.5(b)(4). It is also recommended that the Company disclose this tax allocation agreement in its Holding Company (Form B) filings each year pursuant to CIC Section 1215.4(b)(3)(H).

TERRITORY AND PLAN OF OPERATION

The Company is licensed to transact property and casualty insurance in the following states: Alaska, Arizona, California, Georgia, Hawaii, Idaho, Iowa, Montana, Nevada, New York, North Dakota, Oregon, Texas, Utah, and Washington. In 2007, the Company became licensed in Wisconsin and it currently has an application pending with Connecticut. The Company was recently approved as an accredited reinsurer in North Carolina.

Direct premiums written in 2006 were $158.5 million of which 91.7% were in California. The next largest state with premiums written was Idaho with 7.7% of the direct premiums written in 2006. Premiums written in Arizona, Hawaii, Iowa, Nevada, Oregon, Texas, and Utah were less than 1% combined. The Company had no writings in 2006 in Alaska, Georgia, Montana, New York, North Dakota, and Washington. The Company stated that it plans to begin writing workers' compensation in New York and Texas in the near future.

In March 2007, the Company began appointing agents in New York. Currently there are 45 appointed agents in New York. Business produced elsewhere is still through independent brokers.

Direct premiums written by line of business in 2006 were as follows: workers' compensation ($146.3 million), group accident and health ($9.6 million), and other liability – claims made ($2.7 million).

All of the Company's direct business is related to the SolutionOne and EquityComp products that are marketed and distributed by an affiliate, American Employers Group, Inc. (AEG). The SolutionOne product is an integrated package combining workers' compensation with payroll services, risk management tools and employment protection coverage and is targeted to small and medium-sized employers in blue collar industries with workers' compensation premiums between $5,000 and $500,000. The payroll services under the SolutionOne product are provided by AEG. EquityComp is a workers' compensation-only product targeted to medium-sized businesses with workers' compensation premiums from $100,000 to $2 million and up (no payroll services are provided). The SolutionOne is the Company's primary product. These products are sold through approximately 1,000 independent brokers and the insurance policies are serviced by the Company's affiliated managing general agent, Applied Risk Services, Inc.

A profit sharing plan is available for workers' compensation accounts with a minimum premium of $100,000. The profit sharing plan is similar to an incurred loss retro plan. The profit sharing plan allows the insured to share in the benefit of good loss experience at the risk of bearing the cost of unfavorable loss experience, within the limits of the plan. Under the profit sharing plan, the profit and risk sharing components are accounted for through protected cell accounts in the Company's affiliated captive risk facility, Applied Underwriters Captive Risk Assurance Company (AUCRAC). The EquityComp program is by design a profit sharing policy. Profit sharing is available under the SolutionOne program. During 2006, 25.5% of the Company's workers' compensation policies had a profit sharing plan.

The group accident and health insurance policy covers accidental death and dismemberment and long-term disability. This coverage is provided through three group master policies issued to affiliates: American Employers Group, Inc., California Employer Group No. 27, Inc., and AEG Processing Center No. 35, Inc.

The other liability – claims made line of business consists of employment practices liability insurance (EPLI) and warranty insurance. EPLI covers the employer's legal expenses in defending against claims brought against the employer involving employment practices (i.e. sexual harassment, wrongful termination, job discrimination, etc.). EPLI does not cover damages for which the employer is liable. Limits of liability are $100,000 each loss and $100,000 in the aggregate. There is a $2,000 deductible per claim. The warranty policy provides tax liability protection, administrative compliance, processing accuracy and compliance warranty in connection with the payroll services provided to the SolutionOne policyholders. Coverages for the EPLI and warranty insurance are provided through two separate master policies issued to AEG.

REINSURANCE

Pooling Agreement

Effective January 1, 2006, the Company entered into a reinsurance pooling agreement with its affiliate, Continental Indemnity Company (CI), formally known as Continental National Indemnity Company. Under this agreement, the Company is the lead pool participant and retains 85% of the pooled business. CI cedes 100% of its direct business to the Company. After applying external reinsurance, the Company cedes CI's pooling percentage of 15% to CI. The Company is responsible for managing and administering the pooled business on behalf of each pooled company and acting as the agent for each pooled company with respect to collecting and disbursing funds. This reinsurance agreement was filed with the California Department of Insurance (CDI) pursuant to California Insurance Code (CIC) Section 1215.5(b)(3), on October 3, 2005 and is currently under review.

Assumed

The Company did not assume reinsurance during the examination period except for the pooling agreement mentioned above.

Ceded

Effective January 1, 2005, the Company entered into a Master Facultative Reinsurance Agreement with its affiliate, Applied Underwriters Captive Risk Assurance Company (AUCRAC). This agreement covers the workers' compensation policies classified as profit sharing (i.e. EquityComp and SolutionOne Profit Sharing) as described above under the section "Territory and Plan of Operation." A captive cell account is established within AUCRAC for each profit sharing participant and each captive cell is a party to the reinsurance agreement between the Company and AUCRAC. Participants pay AUCRAC a security deposit to capitalize their captive cell account and the Company cedes a portion of each participant's workers' compensation premiums to fund each participant's captive cell.

Under the above reinsurance agreement, AUCRAC reinsures the Company for a layer of aggregate loss above each participating insured’s attachment point and up to the participating insured’s retention point as set forth in the Participating Client’s proposal. Losses below the insured’s attachment point and losses above the loss retention point are paid by the Company. The participating insured’s retention consists of the security deposit and the premiums ceded by the Company to AUCRAC. AUCRAC is an unauthorized reinsurer and, as such, the Company withholds the premiums to secure the losses ceded to AUCRAC. Since losses ceded may exceed the funds withheld, the Company should only take reserve credits for the funds it actually holds to be in compliance with CIC Section 922.5.

Additionally, the Company was not in compliance with CIC Section 1215.5(b)(3) because it did not provide prior notice to and obtained approval from the CDI for the above reinsurance agreement with AUCRAC. On December 29, 2006, this reinsurance agreement was filed with the CDI pursuant to CIC Section 1215.5(b)(3) and is currently under review.

Effective March 24, 2003, the Company entered into a 100% quota share reinsurance agreement with Coregis Insurance Company (Coregis). This agreement was entered into at the time of the Company’s sale to Applied Underwriters, Inc. and it covers the Company’s run-off business. Under this agreement, Coregis agrees to reinsure 100% of all reported and unreported liabilities incurred prior to the sale date (accident years 2003 and prior losses) and to assume full responsibility for administering and servicing policies and adjusting and paying claims. The Company assigned its rights to any salvage, subrogation and other recoveries in connection with the liabilities reinsured to Coregis. Coregis' liabilities for each policy begins simultaneously with that of the Company's and terminate at the same time as when the Company's liability for its policy or contract expires.

ACCOUNTS AND RECORDS

Schedule T Premiums

The Company's group accident and health and employment practices liability insurance (other liability – claims made) lines of business are provided under group policies that are issued in Idaho. However, nearly all of the certificate holders are in California.

The allocation of premiums in Schedule T during the examination period for the above lines of business is not in accordance to the Rule of 500. Certificate holders under the above group policies exceed 500 and the premiums should be allocated based on the certificate holder's state of residence. The Company stated that it has restated its premium tax reports and filed the reports with California on September 13, 2007.

Claims Practices

A Claims Specialist from the California Department of Insurance performed a review of the Company's claims practices during the examination. The Company supplied a claims practices and procedures manual that was not comprehensive. It is recommended that the Company develop a more comprehensive claims practices and procedures manual that specifies the Company's requirements and guidelines.

Information System Controls

During the course of the examination, a review was made of the Company's general controls over its information systems. As a result of the review, some weaknesses in controls were noted in the areas of disaster recovery/business continuity planning, data backup procedures, physical security, and policies and procedures. The weaknesses noted were presented to the Company along with recommendations to strengthen its controls.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2006

Underwriting and Investment Exhibit for the Year Ended December 31, 2006

Reconciliation of Surplus as Regards Policyholders from December 31, 2001 through December 31, 2006

Statement of Financial Condition
as of December 31, 2006

Assets	Ledger and Non-ledger Assets	Non-Admitted Assets	Net Admitted Assets	Notes
Bonds	$ 40,765,814	$	$ 40,765,814	(1)
Cash and short-term investments	119,411,020		119,411,020	(2)
Investment income due & accrued	535,850		535,850	
Premiums and agents' balances in course of collection	1,472,952	8,055	1,464,897	
Deferred premiums, agents' balances and installments booked but deferred and not yet due	1,086,901	13,036	1,073,865	
Reinsurance recoverables	1,193,092		1,193,092	
Net deferred tax asset	1,943,301	1,540,068	403,233	
Guaranty funds receivable	378,579		378,579	
Electronic data processing equipment	20,469	20,469		
Receivable from parent, subsidiaries and affiliates	7,870,745		7,870,745	
Aggregate write-ins for other than invested assets	422,312		422,312	
Total assets	$175,101,035	$ 1,581,628	$173,519,407	

Liabilities, Surplus and Other Funds

Liabilities, Surplus and Other Funds			Notes
Losses		$ 40,552,186	(3)
Reinsurance payable on paid losses and loss adjustment expenses		178,304	
Loss adjustment expenses		13,994,698	(3)
Commissions payable, contingent commissions and other similar charges		(3,442,374)	(4)
Other expenses		64,101	
Taxes, licenses and fees		2,252,746	
Federal and foreign income taxes		3,079,654	
Unearned premiums		309,486	(5)
Ceded reinsurance premiums payable		(5,947,217)	
Funds held by company under reinsurance treaties		22,627,496	(6)
Provision for reinsurance		5,828,265	(6)
Payable to parent, subsidiaries and affiliates		63,359	
Schedule P provision		6,220,355	
Total liabilities		85,781,059	
Common capital stock	$ 3,000,000		
Gross paid in and contributed surplus	53,560,000		
Unassigned funds	31,178,348		
Surplus as regards policyholders		87,738,348	
Total liabilities, surplus and other funds		$173,519,407	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2006

Statement of Income

Underwriting Income		
Premiums earned		$93,270,305
Deductions:		
Losses incurred	$37,038,300	
Loss expenses incurred	12,781,937	
Other underwriting expenses incurred	15,056,970	
Premium tax reimbursement from affiliate	(1,041,460)	
Total underwriting deductions		63,835,747
Net underwriting gain		29,434,558
Investment Income		
Net investment income earned	$ 3,018,887	
Net realized capital gains	21,751	
Net investment gain		3,040,638
Other Income		
Miscellaneous income	$ 15,325	
Total other income		15,325
Net income before federal income taxes		32,490,521
Federal income taxes incurred		12,769,235
Net income		$19,721,286

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2005		$79,172,182
Net income	$19,721,286	
Change in deferred income tax	1,451,947	
Change in nonadmitted assets	(1,201,447)	
Change in provision for reinsurance	(5,495,265)	
Gains and losses in surplus	(5,910,355)	
Change in surplus as regards policyholders for the year		8,566,166
Surplus as regards policyholders, December 31, 2006		$87,738,348

Reconciliation of Surplus as Regards Policyholders
from December 31, 2001 through December 31, 2006

Surplus as regards policyholders, December 31, 2001, per Examination			$ 7,467,521
	Gain in Surplus	Loss in Surplus	
Net income	$39,897,774	$	
Change in net deferred income tax	1,883,787		
Change in nonadmitted assets		1,522,114	
Change in provision for reinsurance		5,828,265	
Change in paid in capital	52,060,000		
Aggregate write-ins for gains and losses in surplus		6,220,355	
Totals	$93,841,561	$13,570,734	
Net increase in surplus as regards policyholders			80,270,827
Surplus as regards policyholders, December 31, 2006, per Examination			$87,738,348

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Bonds

During the examination period, the Company's bond securities were held by Morgan Stanley, which is not a qualified custodian under California Insurance Code (CIC) Section 1104.9(a)(1). Additionally, the securities were not held pursuant to an approved custodial agreement in violation of CIC Section 1104.9(c). On December 13, 2007, the Company entered into a custodial agreement with Union Bank of California that was submitted to and approved by the CDI on January 24, 2008. The Company stated that all bond securities have been transferred to Union Bank of California.

(2) Cash

The Company's cash accounts are held outside of California in excess of legal requirements and reasonable business needs of the insurer in violation of CIC Section 1104.1. The Company stated that its cash equivalents are in process of being sold and the cash transferred to a California bank.

(3) Losses and Loss Adjustment Expenses

A Casualty Actuary from the California Department of Insurance (CDI) reviewed the Statement of Actuarial Opinion and actuarial report prepared by the Company's actuary and concurred with the conclusion that the loss and loss adjustment expense reserves are reasonable.

During the performance of completeness testing on the Company's claims inventory at December 31, 2006, it was noted that there were seven claims reported in 2006 that were improperly excluded from the claim inventory at December 31, 2006. The Company stated that the cause for this was a breakdown in communications between the department entering the claims and the department preparing the year-end reports. The CDI actuary was informed of this finding and it was determined that there is no material impact on the actuarial analysis. It is recommended that the Company develop procedures to ensure that the year-end claims inventory is complete.

(4) Commissions Payable, Contingent Commissions and Other Similar Charges

The Company is allowed a provisional ceding commission under an expired reinsurance contract with National Indemnity Insurance Company. The base ceding commission is 20 percent and may be adjusted up or down five percent depending on the loss experience on the business ceded. The contract requires the commission to be readjusted annually for each contract accident year and it requires the Company to repay a portion of the ceding commission received in the event the loss ratio exceeds 67 percent.

During 2006, the Company did not update the provisional ceding commission accrual for accident year 2005 and did not set up an accrual for accident year 2006. Statement of Statutory Accounting Principles (SSAP) No. 62, paragraph 46, requires an accrual to be maintained for reinsurance treaties that have an adjustable commission based on loss experience. The Company's failure to update and record the commission adjustment in 2006 did not have a material impact on surplus and no examination adjustment was made. It is recommended that the Company accrue for the provisional ceding commission to comply with SSAP No. 62, paragraph 46.

The Company was unable to demonstrate its compliance with SSAP No. 71, paragraph 3, because there are no written agreements with brokers. SSAP No. 71, paragraph 3, requires that contingent commission liabilities be determined in accordance with the terms of each individual commission agreement. It is recommended that the arrangements with brokers be formalized in a written agreement to comply with SSAP No. 71, paragraph 3, and as a matter of prudent business practice.

(5) Unearned Premiums

The Company uses an "accelerated" method for calculating unearned premiums. This method is not in compliance with SSAP No. 53, paragraph 7. The only methods permitted under SSAP No. 53, paragraph 7, are the monthly pro-rata and daily pro-rata methods. No examination adjustment was made since the difference is not material. It is recommended that the Company comply with SSAP No. 53, paragraph 7. The Company stated that they will begin complying with SSAP No. 53, paragraph 7, starting in 2007.

(6) Funds Held by Company under Reinsurance Treaties and Provision for Reinsurance

A portion of the security for the Company's funds held under reinsurance treaties on behalf of an affiliated unauthorized reinsurer was an intercompany receivable and does not qualify for reinsurance credit under CIC Section 922.5(a). CIC Section 922.5(a) requires that the security under this subdivision be in the form of cash or securities authorized as general investments under Article 3 (commencing with Section 1170) of Chapter 2 of the California Insurance Code, or securities listed by the Securities Valuation Office of the NAIC, qualifying as admitted assets under the CIC and with liquidity meeting the requirements of CIC Section 706.5. No examination adjustment was made since the amount involved is not material. The Company stated that going forward it will only take reserve credit for the funds held based on authorized cash and securities under CIC Section 922.5(a).

The letter of credit held by the Company on behalf of an unauthorized reinsurer is not in compliance with CIC Section 922.5(b)(1) because the letter of credit expired on December 31, 2006, and was not renewed. Under CIC Section 922.5(b)(1), credit for reinsurance ceded to an unauthorized reinsurer may be granted only if the letter of credit is effective no later than December 31st in respect of the year for which filing is being made, and in the possession of the ceding insurer on or before the filing date of its annual statement. No examination adjustment was made since the amount involved is not material. It is recommended that the Company comply with CIC Section 922.5(b)(1).

Additionally, the letter of credit above was reviewed and it was noted that it is missing some of the provisions required for letters of credit under CDI Bulletin 97-5 Sections 9(b) and 9(d). Pursuant to Section 9(b), the letter of credit should include a definition of "beneficiary" to include any successor of the beneficiary by operation of law of the named beneficiary. Pursuant to Section 9(d), the letter of credit should contain a provision that states to the effect that the obligation of the financial institution under the letter of credit is in no way contingent upon reimbursement with respect thereto. It is recommended that the Company ensure that its letters of credit comply with CDI Bulletin 97-5 Sections 9(b) and 9(d) going forward.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Management and Control – Management Agreements (Page 5): It is recommended that the Tax Allocation Agreement be amended to comply with the California Department of Insurance's (CDI) requirements for tax allocation agreements. Additionally, it is recommended that the Company submit this tax allocation agreement to the CDI for approval pursuant to California Insurance Code (CIC) Section 1215.5(b)(4) and disclose this tax allocation agreement in its Holding Company (Form B) filings each year pursuant to CIC Section 1215.4(b)(3)(H).

Reinsurance - Ceded (Page 10): The Company should only take reserve credits for the funds it actually holds to be in compliance with CIC Section 922.5.

Accounts and Records - Claims Practices (Page 12): It is recommended that the Company develop a more comprehensive claims practices and procedures manual, which specifies the Company's requirements and guidelines with respect to claim handling.

Comments on Financial Statement Items – Losses and Loss Adjustment Expenses (Page 17): It is recommended that the Company develop procedures to ensure that the year-end claims inventory is complete.

Comments on Financial Statement Items – Commissions Payable, Contingent Commissions and Other Similar Charges (Page 18): It is recommended that the Company set up an accrual for the provisional ceding commission and comply with Statement of Statutory Accounting Principles (SSAP) No. 62, paragraph 46. Additionally, it is recommended that the arrangements with brokers be formalized in a written agreement to comply with SSAP No. 71, paragraph 3, and as a matter of prudent business practice.

Comments on Financial Statement Items – Unearned Premiums (Page 19): It is recommended that the Company use a method prescribed under SSAP No. 53, paragraph 7, when calculating unearned premiums. The Company stated that they will begin complying with SSAP No. 53, paragraph 7, starting in 2007.

Comments on Financial Statement Items – Funds Held by Company under Reinsurance Treaties and Provision for Reinsurance (Page 19): It is recommended that the Company ensure that its funds held under reinsurance treaties comply with CIC Section 922.5(a).

It is recommended that the Company ensure that its letters of credits comply with CIC Section 922.5(b)(1) and comply with CDI Bulletin 97-5 Sections 9(b) and 9(d).

Previous Report of Examination

None

ACKNOWLEDGMENT

The cooperation and assistance rendered by the officers and employees of the Company during the examination is hereby acknowledged.

Respectfully submitted,

/s/

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Examiner-In-Charge
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